taxes he would get some credit for the taxes the United Kingdom company paid. However, a foreign shareholder who does not have to pay United Kingdom taxes, does not get any credit at all. So he ends up paying more overall than if he were a United Kingdom national. That is a difficult problem to solve. In the United Kingdom treaty it was solved by the United Kingdom Inland Revenue making refunds of money to United States taxpayers who get dividends from the United Kingdom companies. That is an oversimplification, but that is essentially what happens. The reason we do not have a large number of tax treaties is just that we are fairly rigid in our approach. The lesson that the United States Treasury learned in United Kingdom treaty ratification process is not going to make us any more flexible. For those reasons it will be difficult to get more tax treaties. In the long run, since the United States has more taxpayers abroad than most foreign countries have in the United States, we lose by this approach.

CARL ESTES

The Foreign Tax Credit

An Overview

The United States provides a foreign tax credit for foreign income taxes paid, rather than exempting foreign income of United States taxpayers from United States tax under the territoriality principle, in order to achieve both equity and neutrality. Equity is served because United States citizens and residents enjoy the benefits of the United States government regardless of the source of their income and, accordingly, their income should bear the same total income tax burden. The United States income tax is payable to the extent it exceeds the foreign income tax on the income. Neutrality is achieved because the United States tax is payable only after allowing a full credit against it for the foreign tax attributable to such income. The total tax burden is then the same in theory whether the income is derived from domestic sources or from foreign sources. The purpose of the foreign tax credit is to avoid double taxation of income, consistent with the dual objectives of achieving both equity and neutrality in taxing foreign source income of United States taxpayers.

In the sixty years that the foreign tax credit has been allowed in the United States, Congress has reconsidered its application many times. In every instance that Congress has changed it, except one, Congress has done so by adjusting the specific limitations on the credit, the so-called per-country or overall type limits in §§ 901(e) and (f), 904, and 907 of the Internal Revenue

Code. In the only instance in which Congress has reconsidered the basic *scope* of the credit, that is, the range of foreign taxes to which it applies, Congress *expanded* the scope of the credit by extending it in 1942 to a foreign tax paid "in lieu of" an income tax. This "in lieu of" credit is presently embodied in § 903 of the Code, and it has been given very broad application by the courts.

Recently, on June 15, 1979, the Treasury Department published comprehensive, new proposed regulations which would redefine and narrow in many instances the scope of the credit.[1] At the same time, in the administration's proposed energy legislation the Treasury Department has proposed additional limitations of the per-country type with respect to foreign oil income.[2] While this proposed legislation would apply only to foreign oil income, and while the principal effects of the new proposed regulations would also be with respect to foreign oil income, the rationale of the new principles supported by Treasury in these actions is extremely disturbing. The proposed regulations are not limited to oil income and, in fact, would result in denial of foreign tax credits in the case of many other industries, such as banking and hard-mineral extractive industries.

As indicated, the Treasury proposes by regulation to redefine and narrow the scope of the credit, an action which Congress has never undertaken in sixty years of periodic legislative review of the operation of the credit. Many of the positions adopted in the proposed regulations are contrary to outstanding court decisions. In many instances, the proposed regulations would have extensive, retroactive effects, thereby throwing into doubt perhaps hundreds of millions of foreign tax credits taken by United States taxpayers in prior years which are still open for additional assessment of United States tax.

The legislative proposals would extend the special limitations on foreign tax credits with respect to oil operations which were adopted by Congress in 1975 and 1976.[3] These limitations would be far more severe, however, than is necessary effectively to limit the credit to foreign taxes paid, as opposed to royalties paid to foreign governments. The approach reflects some fundamental inconsistencies in principle. Furthermore, there is no reason the United States tax system should maintain more severe limitations on the credits of oil companies than on the credits of other industries except to the extent necessary to distinguish taxes from royalties.

At present, some 25 to 28 billion dollars in foreign tax credits are taken by United States taxpayers of which only 16 to 18 billion dollars are attributable to oil companies. The allowance of this credit is a critical factor in the com-

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[1]Notice of Proposed Rulemaking, U.S. Treasury Department, 44 Fed. Reg. 36,071 (June 20, 1979); *see also* Treasury Department News Release B-1662, 7910 CCH Std. FED. TAX REP. ¶ 6672, June 15, 1979.

[2]*Foreign Tax Credit for Oil and Gas Extraction Taxes: Hearings Before the House Comm. on Ways and Means,* Part 1, Serial 96-22, at 4 (1979) (statement of W. Michael Blumenthal, Secretary of the Treasury).

[3]*See Hearings, supra* note 2 at 188 (statement of Donald C. Lubick, Assistant Secretary for Tax Policy, U.S. Treasury Department (July 26, 1979)).

petitive position of United States industry in world trade. Except for the royalty versus tax issue with respect to the extractive industries, no apparent major issue of principle is unresolved in the application of the foreign tax credit. We must be certain that basic principles of equity and neutrality really necessitate significant changes in the scope of the credit. The Treasury's proposals both in the proposed regulations and legislation seem to go beyond what is necessary to preserve the integrity of the credit.

Operation of the Credit

Before looking to the detailed operation of the new Treasury proposals, it is worthwhile to re-examine some fundamentals. The credit is allowed only for foreign *income* taxes, or foreign taxes imposed *in lieu of* income taxes. The purpose is only to avoid double taxation of *income*. There is a fundamental underlying economic assumption that, in general, taxes other than income taxes are passed forward in increased prices or backward in reduced wages and thus do not burden the investors who earn the income by dedicating their capital to these purposes. In contrast, the assumption is that income taxes do fall upon the investor. Thus, it is necessary to provide a credit only for *income* taxes to avoid a burden of double taxation.

In extending the credit to taxes in lieu of income taxes in § 903, Congress explicitly sought in 1942 to expand the scope of the credit to any foreign tax imposed in lieu of a general income tax imposed by such country.[4] The Court of Claims in the *Metropolitan Life Insurance Company* case in 1967 gave this provision the broadest possible application.[5] The Treasury's new, proposed regulation would adopt a new test for its application which would create great uncertainty. The in-lieu-of credit would be allowed under these new rules only if the foreign tax is comparable in amount to the amount which would generally be paid by the taxpayers subject to such tax if they were subject instead to the general income tax of such foreign country.[6] This test would be applied with respect to the general application of the in lieu of tax, not its application in any particular case.

The regulations do not indicate how this extraordinary comparison of the effect of the in-lieu-of tax under the foreign law could be made, and in many instances it could not be made. The very purpose of granting the in-lieu-of credit in 1942 was that foreign governments had found it difficult or impossible to impose their general income tax on some industries.[7] Such a limitation on the in lieu of foreign tax credit was specifically rejected in the *Metropolitan Life Insurance Company* case and, in the absence of congressional ratification of the proposed regulations, it is difficult to understand how the Treasury expects to sustain this new limitation.

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[4]S. REP. No. 1631, 77th Cong., 2d Sess. 131-33 (1942).

[5]Metropolitan Life Ins. Co. v. United States, 375 F.2d 835 (Ct. Cl. 1967).

[6]Proposed Reg. § 1.903-1(a)(3), *supra* note 1.

[7]S. REP. No. 1631, *supra* note 4.

As previously indicated, the foreign tax credit has traditionally been limited by "per-country" or "overall" type limitations. These limitations serve to restrict the credit to the amount of United States tax attributable to the foreign source income which is subject to foreign tax. The overall limitation looks at all foreign source income of a United States taxpayer as a whole and limits the credit to the same percentage of taxable income from all foreign sources which the United States tax before credit bears to taxable income from all sources, foreign and domestic. In other words, the effective United States tax rate before credit is applied to *all foreign source taxable income* to limit the credit to the amount of United States tax deemed allocable to such foreign source income.

The effect of the overall limitation is to allow averaging of foreign taxes as between high tax and low tax countries by limiting the credit only to the effective United States tax on foreign source income as a whole. As a result, however, foreign losses in one country will reduce foreign source income as a whole, thereby making the limitation on the credit more severe.

The per-country limitation operates more discretely by limiting the credit to the effective United States tax deemed allocable to foreign source taxable income from each particular country. As a result, losses in one country do not reduce the allowable credit with respect to taxes paid to another foreign country, but high taxes in one country cannot be averaged with low foreign taxes in another country. Losses in a foreign country could be offset against United States source income to reduce United States tax under the per country limitation rule.

From 1954 to 1976, United States taxpayers could choose either the overall or per-country limitation but could not switch back and forth. Most established industries not engaged in high risk operations used the overall limitation in order to average high and low foreign tax countries. The oil companies tended to use the per-country limitation so that exploration losses would not reduce their credit in countries where they had refining and marketing operations, as in Europe, but instead could be offset against United States source income.

The determination of *taxable* income from foreign sources, whether on an overall basis or on a per-country basis, requires an allocation of deductions between United States source income and foreign source income. The problem is much more severe on a per-country basis where deductions must be further allocated between each foreign country in which the taxpayer operates. Several years ago the Treasury issued the infamous § 861 regulations which required greatly increased allocation of deductions to foreign source income, thereby often increasing the severity of the limitation and reducing the credit.[8]

In 1975 Congress eliminated the per-country limitation for oil companies

[8]Treas. Reg. § 1.861-8.

and, in 1976, for all taxpayers.[9] In 1975 and 1976, Congress also limited the credit for extraction income for oil companies to what is now 46 percent of foreign source taxable income from extraction, thereby presuming in effect that foreign taxes on extraction income in excess of 46 percent were royalties.[10] This was done, however, on an overall basis so that high foreign taxes on extractive income in one country were averaged with low foreign taxes on extractive income in another country in applying the 46 percent limit. Extractive losses in a country were not taken into account in applying this limit. Congress also imposed on oil companies a special overall limitation with respect to all oil-related income, including extractive income, to limit the credit of oil companies with respect to all oil-related foreign source income to the effective rate of United States tax deemed allocable to such income as a whole.[11]

In prior years, Congress has imposed some similar overall-type limitations on special classes of income, such as interest income and DISC income[12] to limit the credit with respect to such classes of income to the effective United States tax deemed allocable to such classes of income, and to prevent inclusion of such income in all foreign source income under the general overall limitation. If such income were taxed at low rates or were not taxed at all (as was often the case) but were included in applying the general overall limitation, the averaging effect operated to allow foreign tax credits for high foreign taxes in some countries, which taxes clearly exceeded the effective United States tax on such income. This frustrated the general purpose of the credit which was to allow a credit only to the extent of double taxation of the same income.

Congress in 1976 also enacted a provision to recapture the tax benefit from offsetting foreign losses against United States source income.[13] Where such an offset has occurred and foreign income is subsequently realized, a recapture occurs to the extent the foreign tax credit would be reduced if such foreign losses were offset against foreign source income in applying the limitations.

At various times prior to 1954, United States taxpayers were subject to both the per-country and the overall limitations, so that the credit was limited to the extent that either one or the other limitation would reduce it. There is a fundamental conceptual inconsistency in such a system. If the United States is to tax worldwide income of its citizens and residents, then to the extent foreign losses are incurred in a foreign country, they must be allowed to reduce total United States taxable income of the United States taxpayer. It is rational to allow a foreign tax credit to the extent the overall limitation does

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[9]Tax Reform Act of 1976, Pub. L. No. 94-455, § 1031, 94th Cong., 2d Sess. (Oct. 4, 1976) (amending Int. Rev. Code of 1954, § 904).

[10]Tax Reduction Act of 1975, Pub. L. No. 94-12, § 601, 94th Cong., 1st Sess. (March 29, 1975).

[11]Pub. L. 94-012, *supra,* § 601, adding § 907(b), Internal Revenue Code of 1954.

[12]Section 904(d), Internal Revenue Code of 1954.

[13]Pub. L. No. 94-455, *supra,* § 1032, adding § 904(f), Internal Revenue Code of 1954.

not reduce it, treating all foreign source income as a whole, thereby averaging foreign taxes with the result that foreign losses may reduce the limitation. It is perhaps even more rational, absent administrative difficulty considerations, to restrict the credit to the United States tax allocable to foreign source income from each particular country. However, on that rationale foreign losses in one country do not and should not limit the credit for foreign taxes paid on income from another foreign country. The application of both limitations at the same time has no rationale. It does nothing more than deny the use of foreign losses in the determination of United States tax on worldwide income on a capricious basis. The foreign loss recapture rules provide adequate protection to United States revenues from obtaining a double benefit with respect to foreign losses. For this reason, in 1976, Congress merely repealed the per-country limitation and adopted the foreign loss recapture rule. Congress rejected proposals to reinstate the pre-1954 law whereby both limitations would be applied.

Treasury Legislative Proposals

It is against this background that the current Treasury legislative proposals and new, proposed regulations should be evaluated. The legislative proposals would apply the § 907 limitation of the credit to 46 percent with respect to extractive income from foreign oil and gas operations on a country by country basis. This is proposed in order to distinguish royalties from taxes on an even more discrete basis than existing § 907 achieves. This, however, would result in an unnecessary overkill. If the particular foreign country has a general income tax applicable to oil and non-oil companies alike, and if the general income tax rate exceeds 46 percent, it is apparent that the tax exceeding 46 percent is not a royalty. There is no reason to discriminate against oil companies and deny them the benefit of the averaging effect of the general overall limitation merely because they are oil companies. At most, the credit with respect to oil extraction income should be limited to the higher of 46 percent or the generally applicable income tax rate applied to foreign oil extractive taxable income from that country.[14]

The second administration proposal in effect would apply both the overall and per country limitations with respect to oil and gas extraction income. The administration would also recapture the theoretical tax benefit obtained from matching losses in one country against income in another country where the tax rate in the income country is lower than the United States tax rate.

These limitations are not necessary to distinguish taxes from royalties. The first administration proposal, amended as suggested, would adequately achieve that purpose. The dual application of the overall and per country limitations has no conceptual justification, as previously stated. The other proposed limitation is equally unnecessary and unjustified in principle. These

[14] *See* Statement of Raphael Sherfy before the Senate Committee on Finance, July 19, 1979.

additional limitations would serve only to treat oil companies much more harshly in the application of the foreign tax credit than other United States industries doing business abroad.

Proposed Regulations

The new, proposed regulations are in part an effort to achieve the same effect as the legislative proposals in the event such proposals are not accepted by Congress. Their effects may be much more severe, however; they would operate in practice to deny credits to oil companies for substantially all foreign taxes presently paid with respect to *all* foreign extractive income, hard mineral as well as oil extractive income. As previously stated, they would also have severe adverse effects on the banking and other industries. With limited exceptions, they would be retroactive in effect.[15]

Initially the proposed regulations set forth criteria to distinguish a tax from other payments to a foreign government. The payment must be compulsory and must not be compensation for a specific benefit. For the payment to be compulsory, the taxpayer must exhaust all effective and practical remedies to reduce it. The taxpayer must take advantage of all deductions, credits, and exclusions under the foreign law. A payment in bona fide settlement of a contested dispute with the foreign government will qualify. Presumably this will require litigation where a dispute exists and cannot be settled.[16]

The requirement that the tax not be compensation for a specific benefit is intended to disqualify royalty payments. The proposed regulations *presume* that *any* charge levied only on those who receive a benefit from government-owned resources or property is not a tax. Thus, a separate industrywide foreign country income tax on oil producers is presumed not to be a tax. This is so even if the foreign government imposes a separately stated royalty, even at customary rates. The presumption can be rebutted only by a clear demonstration that no part of the charge is compensation for a specific benefit received.[17]

A charge is not presumed to be compensation for a specific benefit, however, if it is imposed under a general income tax statute which applies to both users of the benefit and nonusers. It also will not be presumed to be a charge for a specific benefit even if it is a separate tax applicable only to users if the rate does not exceed 46 percent. If, however, the rate exceeds 46 percent, the entire charge is presumed not to be a tax; the amount up to 46 percent is not treated as a tax.[18] This seems unduly harsh.

Foreign social taxes on employees or self-employed persons are not presumed to be charges for a specific benefit unless determined on an actuarial

[15]Proposed Reg. § 1.901-2(i), *supra*, note 1.
[16]Proposed Reg. § 1.901-2(a)(1), (2), *supra*, note 1.
[17]Proposed Reg. § 1.901-2(a)(3), *supra*, note 1.
[18]Proposed Reg. § 1.901-2(a)(3).

basis. Payments of a charge for which an individual receives benefits under the United States social security system under a totalization agreement between the foreign government and the United States will not, however, be treated as a tax.[19]

This technique in the regulations of establishing a general rule which tends to deny the credit and of then providing specific exceptions where the payment should qualify for the credit is a dangerous approach. Many payments will not qualify for the credit simply because a sufficiently broad exception is not provided, likely because no one foresees the need at this time. Given the purpose and importance of the credit, the analysis should be just the reverse. Payments should qualify unless specific exceptions provide a rational basis for denying the credit.

To qualify for the credit the tax must be based on "*realized net income*."[20] This simple test will lead to wholesale denials of the credit. The test also denies the credit for foreign taxes which are allowed only to the extent the United States allows a credit, so-called soak-up taxes.[21]

The test first requires that the tax be based on *income,* which is specifically designed to exclude wealth, accumulated profits, or other non-income amounts. The tax, however, will not be deemed to be imposed on accumulated profits solely because it is computed on average net income for some prior years. This test does, however, deny credits for taxes based on wages paid, the value of capital, a specified return on capital, or similar notional taxes.[22]

The test requires that the tax must be imposed on the *realization* of income. This test is deemed satisfied if the legal liability to pay the tax results from an event which is treated as realization under the United States Internal Revenue Code. The test is also deemed satisfied if the tax is imposed on an event *subsequent* to the actual realization of the income. A tax imposed on an event *prior to* actual realization will never qualify, however, unless imposed on the export of inventory-type property and on the basis of the fair market value of the property at the time of export. With a startling degree of rigidity, the examples indicate that a tax imposed on the export of property based on the average of prices at which the goods were sold over a previous four months' period will not qualify for the credit.[23]

The test requires that the tax be based on *net* income. The regulations require for this purpose that there be a reasonable opportunity to recover all significant expenses and capital expenditures incurred in deriving gross receipts. An example provides that if the foreign country limits deductible expenses to 80 percent of gross receipts, the tax will not qualify for the credit.

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[19]Proposed Reg. § 1.901-2(a)(3)(iv).
[20]Proposed Reg. § 1.901-2(b).
[21]Proposed Reg. § 1.901-2(b)(1).
[22]Proposed Reg. § 1.901-2(b)(2).
[23]Proposed Reg. § 1.901-2(b)(3), (d) (Example 3).

The examples also indicate that taxpayers must be allowed to amortize capital expenditures over a reasonable period. Another example indicates that if an oil company is required to organize a separate corporation for each separate oil well and is not permitted to file consolidated returns, so that losses from drilling an unsuccessful well in the country cannot be applied to offset income from another successful well in that country, the tax will not qualify for the credit. If, on the other hand, the foreign law merely requires that each separate line of business be incorporated separately, while allowing reasonable carryover of net operating losses from one year to another, even though consolidated returns are not permitted, the tax may qualify for the credit.[24]

With respect to typical foreign withholding taxes on interest and dividends, the proposed regulations provide that expenses and capital expenditures incurred by persons deriving such income other than in the conduct of a trade or business in the foreign country are presumed not to be significant in realizing such income. Accordingly such expenses need not be deductible to enable the withholding tax to be creditable. The same rule is provided for employees deriving income from personal services, such as wages, subject to foreign withholding taxes on such income.[25]

The astonishing aspect of this provision is that it extends only to dividends, interest, and personal service income. This may well mean that withholding taxes on royalties are not creditable unless there is provision for deduction of some expenses and capital expenditures. Other provisions in the proposed regulations permitting foreign gross income taxes to qualify for the credit if not derived from the "conduct of commerce" in the foreign country may cover the typical foreign withholding tax on royalties, but this is far from clear under the regulations.[26]

The proposed regulations make no effort to qualify foreign taxes for the credit under the in lieu of provisions of § 903 of the Code where they fail as foreign income taxes under the new tests proposed. This is very unfortunate. The terms of § 903 of the Code, its legislative history, and its judicial interpretation offer every opportunity to the Treasury to qualify foreign taxes for the credit under this provision even where they cannot be said to be foreign *income* taxes. The Treasury has rejected a golden opportunity to avoid creating major new impediments to foreign trade by United States companies.

Conclusion

There is very little, if anything, to be said for the current Treasury tax policy positions on the foreign tax credit. At stake may be the competitive position of many United States industries in the world market, not to mention the creation of severe roadblocks to the discovery of new energy sources

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[24]Proposed Reg. § 1.901-2(b)(4), (d).
[25]Proposed Reg. § 1.901-2(b)(4)(ii).
[26]Proposed Reg. § 1.901-2(b)(4)(iii).

abroad. The Treasury has every opportunity to take the opposite position and support rather than harm our own interests. The administration should completely reevaluate its general direction in this respect, withdraw the proposed regulations as well as some published rulings issued in 1978 and 1979 to the same effect, modify its legislative proposals as to the tax credit for oil companies, and provide the kind of intelligent tax policy direction that this country needs and deserves.

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